**PADCO/U.S.A.I.D. SOCIAL SECTOR RESTRUCTURING PROGRAM**
**PADCO International Inc., Frolovskaya 6/8 Corpus 1, Kyiv, Ukraine, 254070**
**Tel: 38 044 463 7615, -16, -18, -19: FAX 38 044 463 7614**
**e-mail: rvaughan@padco.kiev.ua**

# PENSION REFORM IN HUNGARY: USEFUL EXPERIENCE FOR UKRAINE

**Prepared by USAID/PADCO**
**under the Social Sector Restructuring Program**

**June 1999**

# PENSION REFORM IN HUNGARY

## INTRODUCTION

Hungary has a population of 10.1 million that is gradually decreasing. The active population (employed plus unemployed) is 4.5 million, of which the officially unemployed account for 15 percent. As of the beginning of 1999, the number of pensioners in the country, including those under early retirement and invalidity arrangements, was 3.2 million or 32 percent (each third) of the total population. The retirement age population is composed mainly of aging women whose medical expense requirements are growing with age. The retirement age was formerly low: 55 years for females and 60 for males. The former pension system was aimed to pay a pension at some 40 percent of the average wage.

The proportion between young plus elderly population and that of working age is high and expected to grow further in foreseeable future. The dependency ratio is presently estimated to be 79 percent in 2001 and to increase up to 87 percent in 2020. From a traditional point of view, making changes in a solidarity scheme means that the current generation will bear not only the pay-as-you-go expenses but also a burden of investment necessary to create a new system. From another point of view, the acquired rights to pensions within the present scheme shall be considered as given sunk costs or an unregistered public debt. In other words, a governmental deficit that specifically results from payment on such claims will merely turn an implicit debt (imaginary debt) into an explicit i.e. real debt.

In 1998, Hungary launched a radical pension reform based on the following principles and **Hungary-specific reform arrangements**:

- dominating will still be the system based on social insurance and solidarity of generations, i.e. the PAYG scheme (the first pillar);
- social insurance will be supplemented with a mechanism of both compulsory (the second pillar) and voluntary (the third pillar) personal pension savings accumulated in private nonprofit pension funds;
- the retirement age will be gradually increased from 55 years for females and 60 years for males up to 62 years for both of the genders by 2008;
- current pensions will be subject to annual indexation based on the Swiss formula that features taking into account a half of changes in CPI and a half of changes in average wage in the industry;
- the payroll tax base will be extended to include all wagelike incomes;
- the payroll tax will be 30 percent and distributed between the first and the second compulsory pillars as follows: in 1998, 6 percent of wage were transferred to the individual pension savings account of participants in the new scheme; in 1999, 7 percent is transferred; and in 2000 the figure will grow by 1 percent more and continue to be 8 percent further on. These contributions will be collected from wages of employees and will not be taxable. Contributions from employers will constitute the rest (24 percent in 1998, 23 percent in 1999, and 22 percent in 2000);
- only wages below 2.5 average wages are subject to payroll tax;
- the new scheme is compulsory for those who first start their employment. Those already working may join the new scheme voluntarily;

- a minimum benefit guarantee will be given to persons with a membership in the new scheme of at least 15 years.

**As a result, it is expected that:**

- these reforms will gradually reduce the volume of solidarity PAYG scheme (the first pillar) and hence the governmental deficit in the future;
- the reforms will considerably increase the volume of domestic private savings;
- the level of pension benefits will be more linked with the level of wages on which these benefits are based;
- a privately set, contribution-funded pension must significantly compensate for a decrease in the pension set by the government, and thus the future pensioners will be better off;
- each third employee voluntarily joined a compulsory pension fund in 1998, and each fourth employee has become a member of a voluntary pension fund;
- the average pension level shall not be lower than the pre-reform level, i.e. 55 percent to 66 percent of the average wage (income);
- the system will guarantee payment of pensions to persons who retired before the reform. Their pensions will be annually increased proportionally with the economic growth to compensate for changes in the real pension value.

Based on the above principles, a legislative package was elaborated to regulate the insurance-pertinent legal relations. The package included: Act of 1993 “On voluntary mutual insurance funds”; Act of 1997 “On social insurance pension”; Act of 1997 “On private pension and private pension funds”; and Act of 1997 “On persons entitled to social security and private pension, as well as on contributions payable to cover the costs of services.”

From May 29 through June 6 1999, a group of 19 Ukrainian experts was on a study tour to Hungary to familiarize themselves with operation of organizations responsible for the functioning of this scheme. The delegation was given an opportunity to learn about pension reform complications, as well as ways to solve the problems that occurred in the process of pension reform.

This report summarizes the Hungarian experience in view of a possibility to make use of it in Ukraine.

## ROLE OF VOLUNTARY PENSION FUNDS

Effective the year of adoption, the Mutual Pension Insurance Act of 1993 made it possible to open voluntary pension funds in Hungary. The experience of their operation played a pivotal role in formation of the second pension security pillar.

The number of and the membership in the voluntary pension funds is steadily growing. Presently, there are 250 such funds, and the number of members has already reached 1 million or almost a quarter of all those employed. In 1998 alone, the voluntary pension funds membership rose by one-third. Employers favor the formation of pension funds because of certain tax privileges.

The voluntary pension scheme (the third pillar) features as follows:

- Voluntary pension fund shall be a privately established nonprofit legal entity.
- Individual accounts of contributors.
- Fund operations include: contribution collection and administration, investment management, pension (annuity) payment, and payment of lump-sum benefits on attainment of retirement age.
- Compulsory appointment of a custodian bank.
- Control by the State Agency for Supervision over Pension Funds.

The concept is to encourage the existing financial institutions (banks, assets management companies, brokers, etc.) to provide services to pension funds.

*Ukraine should probably make use of the Hungarian experience of advance introduction of a third-pillar, non-state pension security for a trial of the entire complex of issues related to a savings-funded pension system. It is the more so as we have similar non-state pension funds already functioning. To this end, however, the legislative, regulative and administrative structures of this system should be formed.*

## COMPULSORY SCHEME FUNDED FROM SAVINGS

The compulsory savings-funded scheme, introduced in January 1998, is the second pillar of the social insurance system. This second component will be binding for persons who start their labor activity. The persons with a service record before 1998 have an option of either joining the new scheme or staying in the former one. However, those wishing to move to the new scheme are supposed to stay in it for not less than 15 years (i.e. persons born after 1951) since it is exactly the period necessary for capitalization of contributions to get an adequate pension. Thus, there will be no inflow of members into the old, solidarity scheme and it will finally disappear. For those who have "suffered" from not getting into the new pension scheme, there will be a state support in a form of (a) tax privileges in case they join voluntary pension funds (the third pillar), and (b) additional employer's contributions at a rate of 6 percent of the wage.

Variants of actuarial estimates were prepared and distributed among the population to help people in taking a decision on a pension scheme choice. In 1998, 1.3 million persons – much more than expected – gave their consent to become members of these second-pillar pension funds. Though, any final conclusion is now premature since the insured have a statutory right to withdraw from the mixed system and return to the system of social security once before Dec. 31 2000.

The second-pillar pension funds are similar to those of the third pillar, however, have some distinguishing features too:

- The number of participants in a pension fund shall be not less than 2,000.

- The statutorily set list of legal entities that may found second-pillar pension funds: employers, chambers of profession, employees' associations, employers' associations, etc.
- A pension fund founder may delegate members to the pension fund board.
- Requirements for a reliable manager and an efficient organizational structure.
- A $50,000 reserve (authorized capital) for "independent" activities.

The insured will have a fundamental right to free choice of a pension fund as well as to unrestricted change of funds. The funds offer different types of annuities and pensions, thus providing for an option. Rules for providing services are fixed by the private pension funds in their statutes

To determine the amount of a pension, single life expectancy at retirement for both males and females is used. This will naturally lead to redistribution of a part of men's incomes in favor of women.

The Hungarian legislative framework provides for physical and legal demarcation between the assets of participants in and the assets of founders of pension funds. This framework guarantees protection of contributions and returns on investment against theft and loss because of bankruptcy. The participants' assets must be kept on a separate bank account that does not belong to the assets management company. It is only a custodian bank that physically possesses the assets of a pension fund's members on their behalf.

There have been set statutory requirements for investments. In particular, a pension fund's assets shall be invested exclusively for the benefit of participants in the fund. The basic investment rules include requirements for diversification, an assets-to-liabilities ratio, and avoidance of unnecessary competition. A general requirement: investments will be only allowed at regulated markets (stock market, automated quotations system). There are certain restrictions with respect to issuers and foreign investments, as well as a list of statutory investments. A governmental decree will form groups of investment elements, set up ceilings in terms of maximum assets percentage that may be invested for each such group, and prescribe rules of assets valuation and return on investment calculation.

*In late 1998, the investment portfolio of compulsory pension funds in Hungary looked like this:*

| | |
|---|---|
| **State securities** | **79%** |
| **Deposits on bank accounts and cash** | **11%** |
| **Shares** | **8%** |
| **Bonds** | **2%** |
| **TOTAL** | **100%** |

As can be seen, the investment portfolio is rather conservative that may be explained, on one hand, by statutory requirements as to minimum guarantees of the assets profitability, and on the other hand, by still high investment risks in Hungary.

*In our view, the Hungarian experience of legal protection of participants' assets may be used in Ukraine when elaborating new bills on pension insurance.*

### GUARANTEES IN SAVINGS-FUNDED SCHEMES

The Hungarian pension system has a number of multilateral, primarily collateral guarantees related to legal regulation of pension funds' assets management, conditions of financial transactions, and strict state supervision. A minimum proceeds guarantee is an internal mechanism of accumulation and distribution in case of a change in the investment results. The government will give no guarantees for the investment activities. Governmental guarantees will only cover stipulated obligations of a guarantee fund. An anticipated average rate of proceeds is determined according to a standard index, and there also are anticipated minimum and maximum rates of proceeds.

The guarantee fund is a pre-established fund to which pension funds pay 0.3 to 0.5 percent of participants' contributions. The fund will also meet claims of a participant in case of fraud or incompetent actions of assets managers.

As for a pension benefit guarantee, a minimum benefit rate has been set only for those insured who will stay in the second-pillar scheme at least for15 years. In such case, the minimum pension benefit will be 25 percent of the first-pillar solidarity pension of a fund participant (*??? – translator*).

In 1998, the total assets of all private pension funds (both compulsory and voluntary) were zooming and rose from 63.4 billion forints in the first quarter up to 131.0 billion forints (approx. $560 million) by the end of the year, i.e. almost doubled.

### SUPERVISION OVER PENSION FUNDS

Even before the first voluntary pension funds of the second pillar sprang up, the government had formed in 1993 a body for state supervision over pension funds' activities. The State Agency for Supervision over Pension Funds is an autonomous administrative body subordinated to the Finance Ministry. In this it is similar to the State Agency for Insurance Supervision but differs from the State Agency for Supervision over Banking and Capital Market that is subordinated directly to the government. The pension funds supervision agency is the only such body for pension funds of both the compulsory second and the voluntary third pillars.

To keep the supervision body, pension funds pay 0.2 percent deductions from their participants' contributions.

The supervision body is composed of departments: legal, licensing, audit, records, investment supervision, benefits, actuarial, coordinating, personnel, information and archival.

A two-stage licensing procedure is applied to compulsory pension funds, namely issue of a foundation license and then a full operation license. After a pension fund is given a foundation license, it will have 180 day to meet all requirements for issue of a full operation license.

There also are strict requirements for record-keeping and accounting. Rules provide for pension funds' quarterly, yearly and actuarial (in case of insurance) reporting.

### REGULATING INFORMATION, ADVERTISING, AND MARKETING ACTIVITIES

Individuals choose a pension fund independently. Majority of people have no idea of financial market operation and do not know which fund is more preferable. In this connection, providing true information to population becomes quite important. Also important is a guarantee that the personnel of pension services providers is properly trained to make offers to their customers in good faith and answer relevant questions.

Pension funds will be bound to communicate the following information for general public:

a) date of the fund operation beginning;

b) names and positions of fund officials;

c) fund's balance sheet;

d) number of participants in the fund;

e) revenues from contributions and other sources;

f) distribution of revenues between reserves;

g) rate of return secured by the fund;

h) administrative expenses;

i) results of investment activities;

j) names of the fund's principles;

k) fines imposed by the supervision body;

l) redress from the Guarantee Fund

m) all other main indicators that allow comparison with other funds' performance.

There are certain information publication rules. In particular, funds have to publish a simplified version of their annual reports that have undergone audit. Funds shall publicize their investment profits and losses and cost-effectiveness figures. The results of investment activities are measured by return with respect to the market value of assets. The funds will be bound to regularly inform their participants on their performance and financial implication, as well as on the state of their accounts. Each fund participant shall receive a statement of his or her individual account at least once a year.

The brochures, booklets and advertisements prepared by a fund must not contain any false information or data. Any description of expected fund performance must include prudent and professionally reasoned estimates, especially when these concern anticipated profits. When the matter is past performance, only data and facts statutorily provided for may be publicized. Presenting the fund performance, CPI changes over respective period must be also specified.

## UPGRADE OF THE PAYG SCHEME

To those who cannot chose the mixed pension insurance system because of their age (i.e. born before 1952) or do not want to move to the new system, pension benefits from 2009 on will be paid within the current, though upgraded system. Until then, no fundamental changes will be made in the pension security system, except for the above-mentioned increase in the retirement age up to 62 years. Until 2013, net earnings (after income tax) will be taken into account since pension is not liable to income tax. After 2013, gross earnings will be taken, as pensions will be considered a taxable income. Starting from 2013, for the insured within the social insurance system, a pension will be equal to 1.65 percent of average earnings for each pensionable year in their insurance period, whereas for those who have joined the mixed system, the pension from the social insurance system will be 1.22 percent of average earnings for each employment period year. In addition, the latter category of employees will be entitled to a pension from the compulsory savings-funded scheme.

Amendments have bee also made in the survivor's pension arrangements. There have bee so far no changes with respect to disability pensions.

In a way, the pension system reform will also involve those who have become unemployed. There is a problem that the unemployed may turn not entitled to a pension.

Insurance period of persons who have incomes below the minimum wage, i.e. employed part time or as homeworkers, will be counted proportionally, and if such persons during their labor activity period earned predominantly less than a half of the minimum wage, they will not acquire a right to pension from social insurance.

## PUBLIC SUPPORT: A BASIS FOR PENSION REFORM SUCCESS

No welfare system reform can be done underground. To be successful, it must be based on a public support.

When there is no consensus between a government and a parliament, and the government has already made up its mind to carry out a pension reform, it should first skillfully present this reform to the people, i.e. carry out a marketing research to find out what kind of reform is going to win support of the population. Constant public opinion monitoring is necessary when preparing and implementing a reform.

Training of employers was the most critical moment in the Hungarian pension reform. It turned out not at all that easy to train 1.5 million persons. The workload of enterprise accountants has increased considerably. The employers whose employees have chosen many different pension funds or often change funds have their hands especially full.

**POTENTIAL FLAWS IN THE HUNGARIAN PENSION SYSTEM:**

- the absence of a centralized automated system for personified record of contributions and earnings of all employees will not add to financial stability of the social insurance system and also implies some other constraints;
- the introduction of compulsory savings-funded scheme at the expense of decreased revenues to the social insurance system generates a great gap in the public finances that, in case of lame control, may cause inflation and other negative consequences;
- guaranteeing a minimum rate of return on investment causes an increase in administrative expenses and do not give any advantages to participants in their choice of pension funds;
- the issues of administrative expenses reduction in the savings-funded system are closely related to legal control over transfer of people from one fund to another, as well as to admission of open-end pension funds.